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The Troubling Return of Keynesianism

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Federal policymakers are moving ahead with a huge $800 billion stimulus plan to return the U.S. economy to growth. Will it work? Decades of macroeconomic research suggest that it won't. Indeed, the revival of old-fashioned Keynesianism to fight the recession seems to stem more from political expediency than modern economic theory or historical experience.

The Errors of Keynes

The idea of using fiscal policy to boost the economy during a downturn was championed by John Maynard Keynes in the 1930s. Keynes argued that market economies can get stuck in a deep rut and that only large infusions of government stimulus can revive growth. He posited that high unemployment in the Great Depression was due to "sticky wages" and other market problems that prevented the return of full-employment equilibrium. Interestingly, Keynes did not offer any evidence that sticky wages were a serious problem, and later research indicated that wages actually fell substantially during the 1930s.[1] Instead, one needs to look at a range of government interventions to explain why the downturn lasted so long.[2]

Despite the flaws in Keynes' analysis, his prescription of fiscal stimulus to increase aggregate demand during recessions became widely accepted. Governments came to believe that by manipulating spending or temporary tax breaks they could scientifically manage the economy and smooth out business cycles. Many economists thought that there was a trade-off between inflation and unemployment that could be exploited by skilled policymakers. If unemployment was rising, the government could stimulate aggregate demand to reduce it, but with the side-effect of somewhat higher inflation.

Keynesians thought that fiscal stimulus would work by counteracting the problem of sticky wages. Workers would be fooled into accepting lower real wages as price levels rose. Rising nominal wages would spur added work efforts and increased hiring by businesses. However, later analysis revealed that the government can't routinely fool private markets because people have foresight and they are generally rational. Keynes erred in ignoring the actual microeconomic behavior of individuals and businesses.

The dominance of Keynesianism ended in the 1970s. Government spending and deficits ballooned, but the result was higher inflation, not lower unemployment. These events, and the rise in monetarism led by Milton Friedman, ended the belief in an unemployment-inflation trade-off. Keynesianism was flawed and its prescription of active fiscal intervention was misguided. Indeed, Friedman's research showed that the Great Depression was caused by a failure of government monetary policy, not a failure of private markets, as Keynes had claimed.

Even if a government stimulus were a good idea, policymakers probably wouldn't implement it the way Keynesian theory would suggest. To fix a downturn, policymakers would need to recognize the problem early and then enact a counter-cyclical strategy quickly and efficiently. But U.S. history reveals that past stimulus actions have been too ill-timed or ill-suited to have actually helped.[3] Further, many policymakers are driven by motives at odds with the Keynesian assumption that they will diligently pursue the public interest.

Rational Expectations and Long-Run Growth

The end of simplistic Keynesianism in the 1970s created a void in macroeconomics that was filled by "rational expectations" theory developed by John Muth, Robert Lucas, Thomas Sargent, Robert Barro, and others.[4] By the 1980s, old-fashioned Keynesian was dead, at least among the new leaders of macroeconomics.[5]

Rational expectations theorists held that people make reasoned economic decisions based on their expectations of the future. They cannot be systematically fooled by the government into taking actions that leave them worse off. For example, people know that a Keynesian-style stimulus might lead to higher inflation, and so they will adjust their behavior accordingly, which has the effect of nullifying the stimulus plan. A spending stimulus will put the government further into debt, but it will not increase real output or income on a sustained basis.

It is difficult to find a macroeconomics textbook these days that discusses Keynesian fiscal stimulus as a policy tool without serious flaws, which is why the current $800 billion proposal has taken many macroeconomists by surprise.[6] John Cochrane of the University of Chicago recently noted that the idea of fiscal stimulus is "taught only for its fallacies" in university courses these days.[7] Thomas Sargent of New York University noted that "the calculations that I have seen supporting the stimulus package are back-of-the-envelope ones that ignore what we have learned in the last 60 years of macroeconomic research."[8]

It is true that Keynesian theory has been updated in recent decades, and it now incorporates ideas from newer schools of thought. But the Obama administration's claim that its stimulus package will create up to four million jobs is outlandish. Certainly, many top macroeconomists are critical of the plan including Harvard University's Greg Mankiw and Stanford University's John Taylor, who have been leaders in reworking the Keynesian model. Taylor noted that "the theory that a short-run government spending stimulus will jump-start the economy is based on old-fashioned, largely static Keynesian theories."[9]

One result of the rational expectations revolution has been that many economists have changed their focus from studying how to manipulate short-run business cycles to researching the causes of long-run growth. It is on long-run growth that economists can provide the most useful advice to policymakers, on issues such as tax reform, regulation, and trade.

Politicians Are Short-Term Oriented

While many economists have turned their attention to long-run growth, politicians unfortunately have shorter time horizons. They often combine little knowledge of economics with a large appetite for providing quick fixes to crises and recessions. Their demand for solutions is often matched by the supply of dubious proposals by overeager economists. Many prominent economists pushed for the passage of the $170 billion stimulus act in early 2008, but that stimulus turned out to be a flop. The lesson is that politicians should be more skeptical of economists claiming to know how to solve recessions with various grand schemes. Economists know much more about the factors that generate long-run growth, and that should be the main policy focus for government reform efforts.

Conclusions

The current stimulus plan would impose a large debt burden on young Americans, but would do little, if anything, to help the economy grow. Indeed, it could have similar effects as New Deal programs, which Milton Friedman concluded "hampered recovery from the contraction, prolonged and added to unemployment, and set the stage for ever more intrusive and costly government."[10] A precedent will be created with this plan, and policymakers need to decide whether they want to continue mortgaging the future or letting the economy adjust and return to growth by itself, as it has always done in the past.

Unfortunately, President Obama has proposed no long-run fiscal reforms, and like his predecessor seems to have a short-run Keynesian outlook. The tax cuts of 2001 and 2003 were generally sold as temporary stimulus measures, and President Bush hailed the 2008 tax rebates as providing a "booster shot" for the economy.[11] It is not clear whether Keynesian beliefs or political factors are the main driver for the $800 billion stimulus plan. But as Harvard University's Robert Barro noted in disapproval of the stimulus plan, just because the economy is in crisis, it does "not invalidate everything we have learned about macroeconomics since 1936."[12]

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[1] Timothy Fuerst, "Perils of Price Deflations: An Analysis of the Great Depression," Federal Reserve Board of Cleveland, February 15, 2001.
[2] For a survey of interventions, see Jim Powell, *FDR's Folly* (New York: Crown Forum, 2003). See also Chris Edwards, "The Government and the Great Depression," Cato Institute Tax & Budget Bulletin no. 25, September 2005.
[3] Bruce Bartlett, "How Not to Stimulate the Economy," *Public Interest* 112 (Summer 1993): 99–109.
[4] For background, see "Rational Expectations" and "New Classical Macroeconomics" at www.econlib.org.
[5] Federal Reserve Bank of Minneapolis, "Interview with Thomas J. Sargent," *The Region*, December 1989.
[6] For example, see N. Gregory Mankiw, *Macroeconomics* (New York: Worth, 2006).
[7] Quoted in *Chicago Tribune*, "The Stimulus Rush," editorial, January 13, 2009.
[8] Ibid.
[9] John Taylor, "Why Permanent Tax Cuts Are the Best Stimulus," *Wall Street Journal*, November 25, 2008.
[10] Jacket blurb for Powell.
[11] *CNNMoney.com*, "Bush Signs Bill Aimed at Boosting Economy," February 13, 2008.
[12] Robert Barro, "Government Spending Is No Free Lunch," *Wall Street Journal*, January 22, 2009.